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COUNTY OF MENDOCINO

**Management Report
For the Year Ended June 30, 2009**

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COUNTY OF MENDOCINO

Management Report For the Year Ended June 30, 2009

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GALLINA^{LLP}

CERTIFIED PUBLIC ACCOUNTANTS

To the Honorable Members of the
Board of Supervisors of the County of Mendocino
Ukiah, California

In planning and performing our audit of the basic financial statements of the County of Mendocino (County) for the fiscal year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered its internal control over financial reporting as a basis for designing our audit procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the County's internal control. Accordingly, we do not express an opinion on the effectiveness of the County's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

We previously reported on the County's internal control in our report dated February 17, 2010 which contains our report on significant deficiencies and material weaknesses in the County's internal control. The following material weaknesses are presented in the Schedule of Findings and Questioned Costs of the Single Audit Report:

- Finding 09-FS-1: Material Weakness: Financial Statement and SEFA Preparation
- Finding 09-FS-2: Material Weakness: American Recovery and Investment Act Requirements
- Finding 09-FS-3: Significant Deficiency: Treasury Reconciliation and Other Items
- Finding 09-FS-4: Significant Deficiency: Accounts Payable
- Finding 09-FS-5: Material Weakness: Accounts Payable and Cash
- Finding 09-FS-6: Material Weakness: Reconciliation of Cash and Investments
- Finding 09-FS-7: Material Weakness: Governmental Trust Funds
- Finding 09-FS-8: Material Weakness: Property Tax Receivable

Honorable Members of the Board of Supervisors
County of Mendocino

During our audit we also became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and suggestions regarding those matters. This letter does not affect our report dated February 17, 2010, on the basic financial statements of the County of Mendocino.

This report is intended for the use of management, the Board of Supervisors, the Grand Jury and officials of the federal and state grantor agencies.

We thank the County's staff for its cooperation during our audit.

A handwritten signature in black ink, appearing to read "Gallina LLP", is written in a cursive, flowing style.

Roseville, California
February 17, 2010

COUNTY OF MENDOCINO

Management Report Required Communication For the Year Ended June 30, 2009

The Auditor's Responsibility under U.S. Generally Accepted Auditing Standards

As stated in our engagement letter dated June 23, 2009, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute assurance that the financial statements are free of material misstatement and are fairly presented in accordance with U.S. generally accepted accounting principles and to express opinions based on the assurance obtained. Because an audit is designed to provide reasonable, but not absolute assurance, and because we did not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us. Our audit of the financial statements does not relieve you or management of your responsibilities.

In planning and performing our audit, we considered the County's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with U.S. Office of Management and Budget (OMB) Circular A-133.

As part of obtaining reasonable assurance about whether the County's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit. Also, in accordance with OMB Circular A-133, we examined, on a test basis, evidence about the County's compliance with the types of compliance requirements described in the OMB Circular A-133 Compliance Supplement applicable to each of its major federal programs for the purpose of expressing an opinion on the County's compliance with those requirements. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination on the County's compliance with those requirements.

Planned Scope of Audit

We performed the audit according to the planned scope and timing previously communicated to you in our engagement letter dated June 23, 2009.

Significant Accounting Policies

Management is responsible for the selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the County are described in Note 1 to the financial statements. The application of existing

COUNTY OF MENDOCINO

Management Report Required Communication For the Year Ended June 30, 2009

policies was not changed during the year. We noted no transactions entered into by the County during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimate(s) affecting the financial statements are discussed below:

- Management believes receivables are fully collectible based on historical experience. Accordingly, no allowance for doubtful accounts is included in the financial statements.
- Management's estimate of risk liabilities and liabilities related to other postemployment benefits is based on either actuarially-determined projections prepared by outside specialists using experiential data gathered over the last several years or, in the case of the County's general liability self-insurance estimate, on open claims and an additional allowance.
- Management's estimate of solid waste landfill closure and post-closure costs is based on an accumulation of the cost of required closure and post-closure activities adjusted for inflation at the rate of 2.7% approved by the California Integrated Waste Management Board.
- Management's estimate of the net pension asset is based on actuarial valuation reports prepared by outside specialists.

We evaluated the key factors and assumptions used to develop these estimates in determining that they were reasonable in relation to the financial statements taken as a whole.

The disclosures in the financial statements are neutral, consistent, and clear. Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosure(s) affecting the financial statements were:

- The disclosure related to other post-employment benefits in Note 12 to the financial statements includes actuarially-determined estimates. The disclosure describes the basis used for determining these estimates.
- The disclosure of contingent liabilities in Note 13 to the financial statements which could have effects in subsequent years even though the amounts are uncertain at this time.

COUNTY OF MENDOCINO

Management Report Required Communication For the Year Ended June 30, 2009

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. The following material adjustments detected as a result of audit procedures were corrected by management:

- Record the activity in the endowment and trust funds reported as special revenue funds, and reclassify cash balances reported as governmental funds, which the County records in trust and agency funds.
- Record an advance for taxes owed from the General Fund to the Tax Resources Fund.
- Account for cash from investment income received by the County but not yet recorded on the general ledger.
- Adjust secured property tax receivable balance to agree to records maintained by the Tax Collector.
- Reclassify cash and accounts payable accounts to account for checks issued after year-end.
- Compute and record a net pension asset in accordance with GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*. The pension asset is a result of contributions in excess of the annual required contribution (ARC), including over contributions resulting from the issuance of pension obligation bonds.

The County agreed to record all of these adjustments to the June 30, 2009 audit report.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

COUNTY OF MENDOCINO

Management Report Required Communication For the Year Ended June 30, 2009

Management Representations

We have requested certain representations from management that are included in the management representation letter dated February 17, 2010.

Management Consultations with Other Independent Auditors

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the governmental unit's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Issues Discussed Prior to Retention of Independent Auditors

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the County's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

COUNTY OF MENDOCINO

Management Report
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AUDITOR-CONTROLLER'S OFFICE

CAPITAL ASSET CAPITALIZATION THRESHOLD

Criteria

The Government Finance Officer's Association (GFOA) recommends that "in no case should a government establish a capitalization threshold of less than \$5,000 for any individual item." Although the GFOA recognizes the importance of maintaining control over items that fall below this threshold, alternatives to capitalization can be used to more efficiently track these lower-value items.

Condition

Currently, the County capitalizes and depreciates all capital assets having an original purchase cost of more than \$2,000 and an estimated useful life in excess of one year.

Cause

The County has historically maintained a lower capitalization threshold to maintain control over more items.

Effect of Condition

According to the GFOA, capital asset management systems that attempt to capitalize and depreciate numerous smaller items are difficult to maintain in practice. This difficulty increases the risk of error as smaller assets are more likely to be ignored by the system's administrators and users. The cost of capitalizing and depreciating these assets is greater than the benefit of achieving control and accountability over these items.

Recommendation

We recommend the County increase its capitalization threshold from \$2,000 to \$5,000.

Management Response

We disagree with the recommendation. Our capitalization threshold will remain at \$2,000 at this time.

While the GFOA 'recommends' the higher threshold, the State Controller's Accounting Standards and Procedures state the County Auditor is to define the value at which an item should be capitalized. The State Controller's range is \$100 to \$5,000.

COUNTY OF MENDOCINO

Management Report
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AUDITOR-CONTROLLER'S OFFICE (continued)

USE OF MISCELLANEOUS REVENUE ACCOUNT

Criteria

The miscellaneous revenue account should be used to record revenues that fall outside of the other revenue categories, such as intergovernmental revenues and charges for services, and that are considered to be infrequent in nature.

Condition

We noted that the County's use of the miscellaneous revenue account (account 827700) includes various types of revenue, including intergovernmental revenues and revenue generated from charges for services. During the audit, we noted that the miscellaneous revenue accounts aggregated for County funds were in excess of \$5.4 million.

Cause

Departments have initial responsibility for classifying cash receipts for financial reporting and may not have adequate knowledge or guidance to properly classify certain revenues. In the absence of other guidance, departments likely record revenues they are unsure of in the miscellaneous revenue account.

Effect of Condition

When revenues are improperly classified as miscellaneous revenues the true condition of the fund may be misleading. The level of detail for classifying transactions should be sufficiently categorized so as to be meaningful to management in making decisions.

Recommendation

We recommend that the County consider restricting the use of its miscellaneous revenue account for revenue sources that cannot be categorized under the existing revenue types, including charges for services, fines, intergovernmental revenues, and licenses and permits.

Management Response

We agree with the recommendation, and will implement miscellaneous revenue restrictions in the upcoming budget.

COUNTY OF MENDOCINO

Management Report
For the Year Ended June 30, 2009

AUDITOR-CONTROLLER'S OFFICE (continued)

RECONCILE CAPITAL ASSET RECORDS TO THE GENERAL LEDGER

Criteria

The County should reconcile transactions included in capital outlay accounts on the general ledger to additions to the capital asset database. Capital asset additions, such as construction in progress in the public works departments, that are not recorded in capital outlay accounts should also be considered.

Condition

During our testing of capital asset transactions and balances, we noted that the County does not reconcile the capital asset purchases recorded in the general ledger to the additions added to the fixed asset database.

Cause

Staff time has not been allocated for this task in prior years.

Effect of Condition

When capital asset purchases are not reconciled to the capital asset listing, errors can occur and not be detected by management on a timely basis. This can result in incomplete or incorrectly categorized capital assets for financial reporting, particularly in construction in progress.

Recommendation

We recommend the County reconcile capital asset purchases and other transactions in the general ledger to the balances and transactions included in the County's capital asset database.

Management Response

We agree with the recommendation.

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Management Report
For the Year Ended June 30, 2009

AUDITOR-CONTROLLER'S OFFICE (continued)

NEGATIVE CASH BALANCES

Criteria

Maintaining positive cash balances in each fund facilitates the Treasurer's cash management activities.

Condition

For several years, we have noted that various County funds carried negative cash balances in the Treasurer's Investment Pool. Though the County recorded interfund liabilities as required by generally accepted accounting principles to eliminate the cash deficits during 2008-09, it has not adopted a policy for addressing overdrawn accounts.

Cause

Deficit cash may be caused by poor budgeting by departments, late billings for reimbursement based grants, or payment delays from other governments.

Effect of Condition

Overdrawn accounts are an indication that cash management policies of the County are not effective or adequate. In some cases, the cash deficits have been caused by failure to manage the flow of cash receipts and expenditures. Essentially, insufficient resources and revenues are being generated to support the continued operations of County programs, especially the Mental Health Services programs. It is important that a periodic review of negative cash balances be conducted and a plan be developed to eliminate the deficit balances. This will ensure that the County's resources are being properly managed.

Recommendation

Initially, we recommended that the County and its departments review all funds with deficit cash balances and determine why the fund has a deficit cash balance and provide a process for the elimination of the deficit, as well as the time frame for doing so.

On an ongoing basis, we recommend that the County continue to implement a process that would reduce the number of funds with a deficit share of the pooled cash. Consideration should be given to implementing cash planning procedures at the department level where each department is held responsible for resolving existing cash deficits and then implementing steps that will prevent or at least minimize deficit cash balances.

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Management Report
For the Year Ended June 30, 2009

AUDITOR-CONTROLLER'S OFFICE (continued)

NEGATIVE CASH BALANCES (continued)

Management Response

We agree that there should be no funds with negative cash balance, but the reality is that, specifically in the Mental Health fund, there is an extreme amount of time between when a claim for reimbursement is made to the State and when they will actually pay it. The County has no control over this. We have taken steps to improve the timeliness of our claiming in Mental Health.

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Management Report For the Year Ended June 30, 2009

AUDITOR CONTROLLER'S OFFICE/COUNTY EXECUTIVE OFFICE

TAX RESOURCES FUND ACCOUNTING

Criteria

The Tax Resources Fund is used to record activity related to the County's secured tax roll billings and tax distributions to the County and various agencies under the Teeter Plan. The fund distributes 100 percent of the base taxes to participating agencies whether the County receives payments from taxpayers or not. Prior year delinquent secured tax collections should be deposited into this fund to cover deficit cash balances resulting from the advance apportionment of taxes to the participating agencies.

Condition

The County's General Fund has been receiving delinquent secured taxes instead of the Tax Resources Fund. As a result, the General Fund has to reimburse Tax Resources Fund for the amounts borrowed.

The following is a five year analysis summarizing the estimated amount of taxes due from the General Fund to the tax loss reserve fund:

	June 30,				
	2009	2008	2007	2006	2005
Negative cash in tax resources fund	\$ 14,513,487	\$ 14,594,668	\$ 13,206,057	\$ 11,084,366	\$ 11,228,685
Less:					
Positive cash in tax loss reserve fund	1,262,715	1,262,715	1,262,715	1,262,715	1,262,715
Secured taxes receivable balance	9,296,690	7,189,634	5,323,849	3,932,195	4,200,808
Penalties	1,028,895	777,443	584,931	441,123	469,283
Estimated amount due by General Fund	<u>\$ 2,925,187</u>	<u>\$ 5,364,876</u>	<u>\$ 6,034,562</u>	<u>\$ 5,448,333</u>	<u>\$ 5,295,879</u>

Cause

Cash requirements in the general fund have prevented repayment over the years.

Effect of Condition

The County's General Fund has been recognizing excess tax revenue and the Tax Resources Fund's deficit cash balance has increased. We would expect that the deficit cash balance would be reduced since taxes and penalties when collected are to be deposited into this fund.

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Management Report
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AUDITOR CONTROLLER'S OFFICE/COUNTY EXECUTIVE OFFICE (continued)

TAX RESOURCES FUND ACCOUNTING (continued)

Recommendation

Initially, we recommended that the County establish a plan to repay the Tax Resources Fund to a point where the outstanding taxes receivable equal the deficit cash. While a plan has been implemented, the difference between the taxes receivable and the deficit cash has not significantly decreased.

On an ongoing basis, we recommend that the County establish a plan to repay the Tax Resources Fund the amount borrowed by the General Fund.

Management Response

We agree with the recommendation, and are working toward a solution to this issue.

COUNTY OF MENDOCINO

Status of Prior Year Recommendations
As of June 30, 2009

Recommendations	Status
<u>AUDITOR-CONTROLLER</u>	
<u>Cash Handling Policies and Procedures Manual</u>	
We recommend that the County develop a cash handling policies and procedures manual to be distributed to each department that handles cash. This should specify the type of collections that a specific department collects the manner of preparing receipts, and the procedures for preparing deposit permits and depositing monies into the County Treasury. The manual should also include the various account numbers into which funds should be deposited so that departments correctly code the deposits into the Treasury.	Memo circulated to all departments.
<u>Negative Cash Balances</u>	
Initially, we recommend that the County and its departments review all funds with deficit cash balances and determine why the fund has a deficit cash balance and provide a process for the elimination of the deficit, as well as the time frame for doing so.	In Process
On an ongoing basis, we recommend that the County implement a process that would not allow a fund's share of the pooled cash to be deficit unless certain approvals from management were in place. Consideration should be given to implementing cash planning procedures at the department level where each department is held responsible for resolving existing cash deficits and then implementing steps that will prevent or at least minimize deficit cash balances.	In Process
<u>Capital Asset Capitalization Threshold</u>	
We recommend the County increase its capitalization threshold from \$2,000 to \$5,000.	The County disagrees with this recommendation.
<u>Use of Miscellaneous Revenue Account</u>	
We recommend that the County consider restricting the use of its miscellaneous revenue account for revenue sources that cannot be categorized under the existing revenue types, including charges for services, fines, intergovernmental revenues, and licenses and permits.	Not implemented.

COUNTY OF MENDOCINO

Status of Prior Year Recommendations
As of June 30, 2009

Recommendations	Status
<u>AUDITOR-CONTROLLER (continued)</u>	
<u>Reconcile Capital Asset Records to the General Ledger</u>	
We recommend the County reconcile capital asset purchases and other transactions in the general ledger to the balances and transactions included in the County's capital asset database.	Not implemented.
<u>RISK MANAGEMENT</u>	
<u>Deficit Equity/Insufficient Reserves</u>	
We recommend that the County review the premiums charged to other funds to determine whether amounts should be increased to cover expected operating expenses.	The County has taken steps to eliminate deficits by increasing premiums. Retiree Health Benefits fund is negative due to the OPEB liability being reported there.
<u>AUDITOR-CONTROLLER/COUNTY EXECUTIVE OFFICER</u>	
<u>Tax Resources Fund Accounting</u>	
Initially, we recommended that the County establish a plan to repay the Tax Resources Fund to a point where the outstanding taxes receivable equal the deficit cash. While a plan has been implemented, the difference between the taxes receivable and the deficit cash is increasing.	Balance decreased this year.
On an ongoing basis, we recommend that the County establish a plan to repay the Tax Resources Fund the amount borrowed by the General Fund.	In Process